

Instructions for Form 8697

(Revised January 1991)

Interest Computation Under the Look-Back Method for Completed Long-Term Contracts

(Section references are to the Internal Revenue Code unless otherwise noted.)

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of interest.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping:

Part I, 8 hrs., 22 min.
Part II, 9 hrs., 5 min.

Learning about the law or the form:

Part I, 2 hrs., 5 min.
Part II, 1 hr., 35 min.

Preparing, copying, assembling, and sending the form to IRS:

Part I, 2 hrs., 19 min.
Part II, 1 hr., 49 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the **Internal Revenue Service**, Washington, DC 20224, Attention: IRS Reports Clearance Officer, T:FP; and the **Office of Management and Budget**, Paperwork Reduction Project (1545-1031), Washington, DC 20503. Do NOT send the tax form to either of these offices. Instead, see the instructions below for information on how to file.

Changes You Should Note

Regulations section 1.460-6(d) provides for a new simplified method for figuring look-back interest. Any taxpayer may elect this method, called the "simplified marginal impact method," except that passthrough entities required to apply the look-back method at the entity level for domestic contracts **must** use the simplified method. Under the simplified method, hypothetical underpayments or overpayments of tax in prior years are figured using an assumed marginal tax rate, which is generally the highest statutory rate of tax in effect for each prior year under section 1 (for an individual) or section 11 (for a corporation). This method eliminates the need to refigure the taxpayer's tax liability based on actual contract price and actual contract costs each time the look-back method is applied. If the simplified method is elected, it must be used in the

election year and all later years, unless IRS consents to a revocation of the election. New Part II of Form 8697 is used to figure the look-back interest under the simplified marginal impact method.

For purposes of reapplying the look-back method after the year of contract completion, Regulations section 1.460-6(e) allows the taxpayer to make a new election that minimizes the number of required reapplications of the look-back method. See **Delayed reapplication method** on page 2 for details.

General Instructions

Purpose of Form

Form 8697 is used to figure the interest due or to be refunded under the look-back method of section 460(b)(2) on certain long-term contracts entered into after February 28, 1986, that are accounted for under either the percentage of completion method or the percentage of completion-capitalized cost method. For guidance concerning these methods, see Notice 89-15, 1989-1 C.B. 634. For information on and computational examples illustrating the use of the look-back method, see Regulations section 1.460-6.

Who Must File

General rule.—You must file Form 8697 for each tax year in which a long-term contract entered into after February 28, 1986, is completed that you accounted for using either the percentage of completion method or the percentage of completion-capitalized cost method for Federal income tax purposes. You also must file Form 8697 for any tax year in which the contract price or contract costs are adjusted for one or more of these long-term contracts from a prior year.

In the case of a passthrough entity (partnership, S corporation, or trust) that is not closely held, the look-back method is applied at the entity level to contracts completed or adjusted in a tax year for which the due date (including extensions) of the return of the passthrough entity is after November 9, 1988, and with respect to which at least 95% of the gross income is from U.S. sources. A passthrough entity is considered closely held if, at any time during any tax year for which there is income under the contract, 50% or more (by value) of the beneficial interests in the entity is held (directly or indirectly) by or for five or fewer persons. For this purpose,

rules similar to the constructive ownership rules of section 1563(e) apply.

If you are an owner of an interest in a passthrough entity for every year in which a long-term contract was being accounted for under the percentage of completion method or the percentage of completion-capitalized cost method and the passthrough entity is not subject to the look-back method at the entity level, you must file this form for your tax year that ends with or includes the end of the entity's tax year in which the contract was completed or adjusted.

If the taxpayer reporting income from a long-term contract changes prior to the year of completion of the contract, the taxpayer as of the date of completion will be responsible for the payment of interest (if any) due from any year in which the contract was being accounted for under either the percentage of completion method or the percentage of completion-capitalized cost method. Generally, only the taxpayer that had accounted for a long-term contract in a year that an overpayment occurred may request a refund of interest on the overpayment.

Exception for certain construction contracts.—The look-back method does not apply to the regular taxable income from:

(a) any home construction contract (as defined in section 460(e)(6)(A)), or

(b) any other construction contract entered into by a taxpayer: (1) who estimates the contract will be completed within 2 years from the date the contract begins, and (2) whose average annual gross receipts for the 3 tax years preceding the tax year in which the contract is entered into do not exceed \$10 million. See section 460(e).

However, the look-back method does apply to the alternative minimum taxable income from any such contract that must be accounted for using the percentage of completion method for alternative minimum tax purposes. See section 56(a)(3) for details.

Small contract exception.—The look-back method does not apply to any contract completed within 2 years of the contract start date if the gross price of the contract (as of contract completion) does not exceed the smaller of:

- (a) \$1 million, or
- (b) 1% of the average annual gross receipts of the taxpayer for the 3 tax years before the tax year of contract completion.

See section 460(b)(3)(B) for details.

Filing Instructions

If you owe interest.—Attach Form 8697 to your income tax return.

- For taxpayers other than partnerships, include the interest due in the amount to be entered for **total tax** (after credits and other taxes) on your return. (For example, 1990 Form 1040, line 54; 1990 Form 1120, Schedule J, line 10, etc.) Write on the dotted line to the left of the entry space "From Form 8697" and the amount of interest due.

• For partnerships, write "From Form 8697" and the amount of interest due in the bottom margin of the tax return, and attach a check or money order for the full amount payable to "Internal Revenue Service." Write the partnership's employer identification number, daytime phone number, and "Form 8697 Interest" on the check or money order.

If interest is to be refunded to you.—Do NOT attach Form 8697 to your income tax return. Instead, file Form 8697 separately with the Internal Revenue Service Center where your income tax return is required to be filed. File the form in a separate envelope from that of your income tax return. Keep a copy of Form 8697 and any attached schedules for your records.

Sign Form 8697 following the instructions for the "Signature" section of your income tax return. If additional Forms 8697 are needed (to show more than 3 prior tax years), sign only the first Form 8697.

File Form 8697 not later than the date you are required to file your income tax return (including extensions).

Filing a Corrected Form 8697

You are required to file a corrected Form 8697 only if the amount shown on Part I, line 6 or Part II, line 7 for any prior year changes as a result of an error you made, an income tax examination, or the filing of an amended tax return.

When completing Part I, line 1 of the corrected Form 8697, follow the instructions on the form but do not enter the adjusted taxable income from Part I, line 3 of the original Form 8697. When completing Part I, line 5 (or Part II, line 6) of the corrected Form 8697, do not include the interest due, if any, from Part I, line 10 (or Part II, line 11) of the original Form 8697 that was included in your total tax when Form 8697 was filed with your tax return.

• If you owe interest on both the original and corrected Form 8697, file an amended tax return following the corresponding filing instructions above and the amended return instructions for your tax return.

• If interest is to be refunded to you on both the original and corrected Form 8697, write "Amended" in the margin at the top of the corrected Form 8697, and file it separately following the corresponding filing instructions above.

• If you owed interest on your original Form 8697, and interest is to be refunded to you on the corrected Form 8697, you must:

(a) File an amended tax return showing \$0 interest from Form 8697, and

(b) File the corrected Form 8697 separately (but do not write "Amended" at the top of the form since this will be the first Form 8697 that you filed separately). Follow the corresponding filing instructions above and the amended return instructions for your tax return.

• If there was interest to be refunded to you on the original Form 8697, and you

owe interest on the corrected Form 8697, you must:

(a) File the corrected Form 8697 separately (with "Amended" written at the top) showing \$0 interest to be refunded, and

(b) File an amended tax return and attach the corrected Form 8697. Follow the corresponding filing instructions above and the amended return instructions for your tax return.

Attachments

If you need more space, attach separate sheets to the back of Form 8697. Be sure to put your name and identifying number on each sheet.

Applying the Look-Back Method Under Special Situations

Change orders.—A change order with respect to a contract is not treated as a separate contract for purposes of applying the look-back method unless the change order would be treated as a separate contract under the rules for severing and aggregating contracts provided in Regulations section 1.451-3(e). Therefore, if a change order is not treated as a separate contract, that portion of the actual contract price and contract costs attributable to the change order must be taken into account in allocating contract income to all tax years of the contract, including tax years before the change order was agreed to.

Treatment of amounts properly taken into account after contract completion.—(a) **General rule.**—If the contract price or costs are revised to reflect amounts properly taken into account after the contract completion date for any reason, the look-back method must be applied in the year such amounts are properly taken into account, even if no other contract is completed in that year. Generally, the amount of each such post-completion adjustment to total contract price or contract costs is discounted, solely for look-back purposes, from its value at the time the amount is taken into account in computing taxable income to its value at the time the contract was completed. The discount rate for this purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account.

However, a taxpayer may elect not to discount post-completion adjustments with respect to any contract. To make this election, attach a statement to your timely-filed tax return (determined with regard to extensions) for the first tax year after completion in which you take into account any adjustment to the contract price or contract costs. The statement must indicate that you are making an election under Regulations section 1.460-6(c)(1)(ii)(c)(2) not to discount post-completion adjustments and must identify the contracts to which the election applies. Once made, the election is binding for all post-completion

adjustments that apply to a contract for which an election has been made.

(b) **Delayed reapplication method.**—For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method. Under this method, the look-back method is reapplied after the contract completion year (or after a later reapplication of the look-back method) only when one of the following conditions is met for that contract:

(1) The net undiscounted value of increases or decreases in the contract price occurring from the time of the last application of the look-back method exceeds the lesser of \$1 million or 10% of the total contract price at that time,

(2) The net undiscounted value of increases or decreases in contract costs occurring from the time of the last application of the look-back method exceeds the lesser of \$1 million or 10% of the total actual contract costs at that time,

(3) The taxpayer goes out of existence,

(4) The taxpayer reasonably believes the contract is finally settled and closed, or

(5) None of the above conditions (1-4) are met by the end of the 5th tax year that begins after the last previous application of the look-back method.

To elect the delayed reapplication method, attach a statement to your timely-filed tax return (determined with regard to extensions) for the first tax year of the election. The statement must indicate that you are making an election under Regulations section 1.460-6(e) to use the delayed reapplication method. Once made, the election is binding for all long-term contracts for which you would reapply the look-back method in the absence of the election in the year of the election and all later years, unless IRS consents to a revocation of the election. See Regulations section 1.460-6(e) for more details.

10-percent method.—For purposes of the percentage of completion method, a taxpayer may elect to postpone recognition of income and expense under a long-term contract entered into after July 10, 1989, until the first tax year as of the end of which at least 10% of the **estimated** total contract costs have been incurred. For purposes of the look-back method, the recognition of income and expense must be postponed for such contracts until the first tax year as of the end of which at least 10% of the **actual** total contract costs have been incurred. Therefore, income and expense will be allocated to a different tax year if the first tax year that the 10% threshold is exceeded based on actual costs differs from the first tax year that the 10% threshold is exceeded based on estimated costs. See section 460(b)(5) for more details.

Specific Instructions

All filers must complete the information at the top of the form above Part I according to the following instructions and complete

either Part I or Part II as appropriate. Also sign the form at the bottom of page 2 unless you are filing the form with your tax return.

Filing Year

Fill in the filing year line at the top of the form to show the tax year in which the contracts for which this form is being filed were completed or adjusted. If you were an owner of an interest in a passthrough entity that has completed or adjusted one or more contracts, enter your tax year that ends with or includes the end of the entity's tax year in which the contracts were completed or adjusted.

Name

Enter the name shown on your Federal income tax return for the filing year. If you are an individual filing a joint return with your spouse, also enter your spouse's name as shown on Form 1040.

Address

Enter your address only if you are filing this form separately. Include the apartment, suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and you have a P.O. box, show the P.O. box number instead of the street address.

A. Identifying number

If you are an individual, enter your social security number. Other filers must use their employer identification number.

Part I

Regular Method

Use Part I only if you are not electing, do not have an election in effect, or are not required to use the simplified marginal impact method as described in the instructions for Part II.

Columns (a), (b), and (c)

Enter at the top of each column the ending month and year for:

- (1) each prior tax year in which you were required to report income from the completed long-term contract(s) and
- (2) any other tax year affected by such year(s).

Note: *If there were more than 3 prior tax years, attach additional Forms 8697 as needed. On the additional Forms 8697 enter your name, identifying number, and tax year; complete lines 1 through 8 (as applicable), but do not enter totals in column (d). Enter totals only in column (d) of the first Form 8697.*

Line 2

In each column, show a net increase to income as a positive amount and a net decrease to income as a negative amount.

In figuring the net adjustment to be entered in each column on line 2, be sure to take into account any other income and expense adjustments that may result from the increase (or decrease) to income from long-term contracts (e.g., in the case of an individual, a change to adjusted gross

income may affect investment expenses under section 212, medical expenses under section 213, etc.).

Attach a schedule that includes the following information:

(a) Identification of each completed long-term contract by contract number, job name, or any other reasonable method used in your records to identify each contract.

(b) For each contract, report in columns for each prior year: (1) the amount of income previously reported based on estimated contract price and costs, and (2) the amount of income allocable to each prior year based on actual contract price and costs. Total the columns for each prior year and show the net adjustment to income from long-term contracts.

(c) Any other adjustments that result from a change in income from long-term contracts must be identified and the amounts must be shown in the columns for the affected years so that the net adjustment shown in each column on the attached schedule agrees with the amounts shown on line 2.

An owner of an interest in a passthrough entity is not required to provide the detail listed in (a) and (b) above with respect to prior years. The entity should provide the line 2 amounts with Schedule K-1 or on a separate statement for its tax year in which the contracts are completed or adjusted.

Note: *Taxpayers reporting line 2 amounts from more than one Schedule K-1 (or a similar statement) must attach a schedule detailing by entity the net change to income from long-term contracts.*

Lines 4 and 5

The tax liability to be entered on lines 4 and 5 must be reduced by allowable credits (other than refundable credits, e.g., the credit for taxes withheld on wages, the earned income credit, the credit for Federal tax on fuels, etc.), but do not take into account any credit carrybacks to the prior year in computing the amount to enter on lines 4 and 5 (other than carrybacks that must be taken into account to properly compute interest under section 460). Include on lines 4 and 5 any taxes (such as alternative minimum tax) required to be taken into account in the computation of your tax liability (as originally reported or as redetermined).

Lines 7 and 8

For the increase (or decrease) in tax for each prior year, interest due or to be refunded must be computed at the overpayment rate determined under section 6621(a)(1) and compounded on a daily basis, generally from the due date (not including extensions) of the return for the prior year until the earlier of:

- (a) the due date (not including extensions) of the return for the filing year, or
- (b) the date the return for the filing year is filed and any income tax due for that year has been fully paid.

Exceptions:

(a) If a net operating loss, capital loss, or credit carryback is being increased or decreased as a result of the adjustment made to net income from long-term contracts, the interest due or to be refunded must be computed on the increase or decrease in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the prior year that generated the carryback and **not** from the due date of the return for the year in which the carryback was absorbed. See section 6611(f).

(b) In the case of a decrease in tax on line 6, if a refund has been allowed for any part of the income tax liability shown on line 5 for any year as a result of a net operating loss, capital loss, or credit carryback to such year, and the amount of the refund exceeds the amount on line 4, interest shall be allowed on the amount of such excess only until the due date (not including extensions) of the return for the year in which the carryback arose.

Tables of interest factors to compute daily compound interest were published in Rev. Proc. 83-7, 1983-1 C.B. 583. The annual interest rate in effect and the table and corresponding page number in 1983-1 C.B. for periods through March 31, 1991, are shown in the following table:

From	Through	Rate	Table	Page
—	6/30/86	10%	16	599
7/1/86	12/31/86	9%	15	598
1/1/87	3/31/87	8%	14	597
4/1/87	6/30/87	8%	14	597
7/1/87	9/30/87	8%	14	597
10/1/87	12/31/87	9%	15	598
1/1/88	3/31/88	10%	40	624
4/1/88	6/30/88	9%	39	623
7/1/88	9/30/88	9%	39	623
10/1/88	12/31/88	10%	40	624
1/1/89	3/31/89	10%	16	599
4/1/89	6/30/89	11%	17	600
7/1/89	9/30/89	11%	17	600
10/1/89	12/31/89	10%	16	599
1/1/90	3/31/90	10%	16	599
4/1/90	6/30/90	10%	16	599
7/1/90	9/30/90	10%	16	599
10/1/90	12/31/90	10%	16	599
1/1/91	3/31/91	10%	16	599

For periods beginning after March 31, 1991, use the overpayment rate under section 6621(a)(1) in the revenue rulings published quarterly in the Internal Revenue Bulletin.

Note: *If a different method of interest computation must be used to produce the correct result in your case, use that method and attach an explanation of how the interest was computed.*

Line 9

Additional interest to be refunded for periods after the due date of the return, if any, will be computed by IRS and included in your refund. The amount on line 9 (or the amount refunded by IRS if different) must be reported as interest income on your income tax return for the tax year in which it is received or accrued.

Line 10

This amount (or the amount computed by IRS if different) is deductible, subject to any applicable limitations under section

163, as interest expense arising from an underpayment of income tax on your income tax return for the tax year in which it is paid or incurred.

Part II

Simplified Marginal Impact Method

Part II is used only by passthrough entities required to apply the look-back method at the entity level (see **Who Must File** on page 1) and taxpayers electing (or with an election in effect) to use the simplified marginal impact method. Under the simplified method, prior year hypothetical underpayments or overpayments in tax are figured using an assumed marginal tax rate, which is generally the highest statutory rate in effect for the prior year under section 1 (for an individual) or section 11 (for a corporation). This method eliminates the need to refigure the actual contract costs each time the look-back method is applied.

To elect the simplified marginal impact method, attach a statement to your timely-filed tax return (determined with regard to extensions) for the first tax year of the election. The statement must indicate that you are making an election under Regulations section 1.460-6(d) to use the simplified marginal impact method. Once made, the election applies to all applications of the look-back method in the year of the election and all later years, unless IRS consents to a revocation of the election.

Columns (a), (b), and (c)

Enter at the top of each column the ending month and year for each prior tax year in which you were required to report income from the completed long-term contract.

Note: *If there were more than 3 prior tax years, attach additional Forms 8697 as needed. On the additional Forms 8697, enter your name, identifying number, and tax year; complete lines 1 through 9 (as applicable), but do not enter totals in column (d). Enter totals only in column (d) of the first Form 8697.*

Line 1

In each column, show a net increase to income as a positive amount and a net decrease to income as a negative amount.

Attach a schedule that includes the following information:

(a) Identification of each completed long-term contract by contract number,

job name, or any other reasonable method used in your records to identify each contract.

(b) For each contract, report in columns for each prior year: (1) the amount of income previously reported based on estimated contract price and costs, and (2) the amount of income allocable to each prior year based on actual contract price and costs. Total the columns for each prior year and show the net adjustment to income from long-term contracts.

An owner of an interest in a passthrough entity is not required to provide the detail listed in (a) and (b) above for prior years. The entity should provide the line 1 amounts with Schedule K-1 or on a separate statement for its tax year in which the contracts are completed or adjusted.

Note: *Taxpayers reporting line 1 amounts from more than one Schedule K-1 (or a similar statement) must attach a schedule detailing by entity the net change to income from long-term contracts.*

Line 2

Multiply the amount on line 1 by the applicable regular tax rate for each prior year shown in column (a), (b), or (c). The applicable regular tax rate is as follows:

(a) Individuals and passthrough entities in which, at all times during the year, more than 50% of the interests in the entity are held by individuals directly or through other passthrough entities:

- (1) Tax years beginning before 1987 50%
- (2) Tax years beginning in 1987 38.5%
- (3) Tax years beginning after 1987 and before 1991. 28%
- (4) Tax years beginning after 1990 31%

(b) C corporations and passthrough entities not included in (a) above:

- (1) Tax years ending before July 1, 1987 46%
- (2) Tax years beginning after June 30, 1987 34%
- (3) For other tax years that include July 1, 1987, the rate is 34% plus the following:

$$\frac{\text{Number of days in tax year before 7/1/87}}{\text{Number of days in tax year}} \times 12\%$$

Line 3

See the instructions for Part II, line 1, and complete line 3 in the same manner, using only income and deductions allowed

for alternative minimum tax (AMT) purposes.

Line 4

Multiply the amount on line 3 by the applicable AMT rate which is as follows:

(a) Individuals and passthrough entities in which, at all times during the year, more than 50% of the interests in the entity are held by individuals directly or through other passthrough entities:

- (1) Tax years beginning after 1986 and before 1991. 21%
- (2) Tax years beginning after 1990 24%

(b) C corporations and passthrough entities not included in (a) above:

- Tax years beginning after 1986 20%

Line 5

If both lines 2 and 4 are negative, enter whichever amount is greater. Treat both numbers as positive when making this comparison, but enter the amount as a negative number. (If the amount on one line is negative, but the amount on the other line is positive, enter the positive amount.)

Lines 8 and 9

For the increase (or decrease) in tax for each prior year, interest due or to be refunded must be computed at the overpayment rate determined under section 6621(a)(1) and compounded on a daily basis from the due date (not including extensions) of the return for the prior year until the earlier of:

(a) the due date (not including extensions) of the return for the filing year, or

(b) the date the return for the filing year is filed and any income tax due for that year has been fully paid.

Tables of interest factors to compute daily compound interest were published in Rev. Proc. 83-7, 1983-1 C.B. 583. The annual interest rate in effect and the table and corresponding page number in 1983-1 C.B. for periods through March 31, 1991, are shown in the table in the instructions for Part I, lines 7 and 8.

Line 10

See the instructions for Part I, line 9.

Line 11

See the instructions for Part I, line 10.